

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of)
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Access Charge Reform)
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Price Cap Performance Review)
for Local Exchange Carriers)
)
Transport Rate Structure)
and Pricing)
)

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

CC Docket No. 96-262

CC Docket No. 94-1

CC Docket No. 91-213

**REPLY COMMENTS OF AMERITECH
ON NOTICE OF PROPOSED RULEMAKING**

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I. INTRODUCTION AND SUMMARY.

In this reply to comments on the Commission's Notice of Proposed Rulemaking in this proceeding,¹ Ameritech will respond to criticisms of the Commission's proposed market-based approach to access reform. In particular, Ameritech will show that this approach is completely consistent with Congress' pro-competitive, deregulatory mandates set forth in the Telecommunications Act of 1996 (the "Act"). Further, Ameritech will demonstrate that the market-based approach facilitates the development of efficient competition by providing

¹ In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, CC Docket Nos. 96-262, 94-1, 91-213, Notice of Proposed Rulemaking, Third Report and Order, FCC 96-448 (released December 24, 1996) ("NPRM").

appropriate incentives for infrastructure investment by both incumbents and new entrants.

Ameritech will explain how the Commission's proposed triggers for the market-based approach will provide sufficient discipline to justify the relief proposed for each phase of that approach. In that regard, price caps will continue to be an important regulatory safeguard in the transition to a market-based access environment. Also, Ameritech will demonstrate that, during the transition, there is no reason not to deregulate those services that provide new functionality since ILECs cannot reasonably charge more than the value of the services.

Further, Ameritech will show that the prescriptive approach favored by several parties is completely inconsistent with the pro-competitive and deregulatory environment envisioned in the Act, and would discourage investment, hinder competition and, ultimately, harm consumer welfare. The fact that competition is emerging eliminates any real justification for such a restructure and inflexible approach to rate making. Moreover, there is nothing in the law that requires the Commission to prescribe access rates at forward-looking incremental cost levels.

Many parties supported generally the principle that the current access rate structure should be revised to be more reflective of the manner in which costs are incurred, including flat rate or competitively neutral billing of the carrier common line ("CCL") charge, and the transport interconnection charge ("TIC").

Ameritech agrees. Despite that fact, several parties asked the Commission to require the continuation of the current "unitary" rate structure for tandem-switched transport. However, a bifurcated rate configuration for tandem-switched transport is a necessary component of access restructuring since it will encourage interexchange carriers ("IXCs") to configure their networks more efficiently.

Finally, a proper approach to access reform cannot involve a flash-cut elimination of the TIC. Because of its role in supporting ILECs' ability to provide affordable basic local exchange rates, anything more drastic than a reasonable (five-year) phase-out would be inappropriate. Moreover, during the transition, that portion of the TIC that is not moved to other rate elements -- *e.g.*, the tandem-switching charge and SS7 related elements -- should be billed to access customers on a competitively neutral basis since it contributes to affordable local exchange service.

II. THE MARKET-BASED APPROACH FACILITATES EFFICIENT COMPETITION.

A. The Market-Based Approach Is Consistent with the Pro-Competitive Intent of the Act.

The Act sets out an objective of the simultaneous development of competition in all telecommunications markets. To this end, a market-based approach should be applied to this industry. The reasons for this policy are not

hard to find: prescription of prices by government leads to reduced economic efficiency and innovation when compared with the results of competitive markets.

The reasons for the greater efficiency and innovation resulting from a market-based approach are discussed in the Reply Statement of Dr. Kenneth Gordon.² As Dr. Gordon points out, the “presence of regulation in fact may prevent the emergence of competition”³

There is little dispute that the emergence of competition is beneficial and that, once real competition is in place, the Commission’s regulation should be relaxed. The real issue is how to manage this transition to facilitate the development of competition and prevent any abuse of any residual market power. Care must be taken that measures designed to facilitate this transition do not inadvertently stifle or distort the natural evolution of competition in the marketplace.

The Act creates the opportunity for reduced government regulation of telecommunications by eliminating any remaining bottlenecks and barriers to competitive entry. Until such time as all areas are themselves competitive, the role of regulation should be to help facilitate this transition so efficient competition can emerge, and to prevent abuse of any residual market power.

² Reply Statement of Dr. Kenneth Gordon (“Gordon Reply”) included as Attachment A (at 17-25).

³ *Id.* at 3.

In this regard, the industry has been caught in a classic "Catch 22" -- regulation will not be reformed until after competition emerges and competition cannot emerge until regulation is first reformed. Congress sought to break this "logjam" by requiring that all barriers to competition be eliminated in all markets simultaneously. The Commission should not re-create the "Catch 22" by re-establishing rigid regulation of access pricing of ILECs until competition is proven to already exist. The effect of this ill-advised policy will be to stifle any real opportunity for efficient competition.

By targeting regulation to the real areas of concern -- interconnection of competing networks and the availability of other essential facilities -- Congress created the opportunity for market forces to bring the benefits of competition to telecommunications services that have been traditionally regulated. With all entry barriers removed, competitors can enter the marketplace to supply the access needs of end users and carriers. The IXCs in addition have the opportunity to vertically integrate and meet their own access needs. However, this can only happen if the Commission is willing to let the competitive marketplace develop and freely operate by adopting policies that afford to ILECs and new entrants the same flexibility to compete.

Thus, the market-based approach to access reform described in the Commission's NPRM is wholly consistent with the course laid out by Congress in 1996 and is the essential step in developing truly efficient competition.

B. The Market-Based Approach Facilitates The Transition To Efficient Competition.

Suppliers and customers of access services (primarily IXCs have the information to make the informed decisions that ensure the efficient provision of access services. Competitors and new entrants in the access marketplace, left to their own devices, will make entry and investment decisions based on their knowledge of current and expected market conditions and their own costs. By contrast, regulatory prescription of access prices will provide the correct pricing signals only by accident or coincidence, since an unbiased source of the information on the dynamics of the competitive market necessary to price services at competitive levels does not exist. In fact, existing methodologies and models do not even attempt to simulate the action of a competitive marketplace. Rather they simply seek to measure cost.

For example, under the market-based approach each competitor (both incumbents and new entrants) are aware of market conditions and the cost characteristics of an efficient network (these are after all their networks). As competitors, they also recognize that prices will move toward cost as entry and competition occur and regulation recedes. However, as Dr. Gordon explains⁴ a competitive marketplace never prices at cost, rather it prices based upon the dynamic interaction of a host of supply and purchase decisions of all suppliers and

⁴ Gordon Reply at 13-14.

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customers.⁵ It is important that prices be allowed to reflect these factors because without them incentives for entry, exit, and innovation would be distorted.⁶ The appropriate response to these factors also provides a vehicle for market adjustments to demand shifts and excess and scarce supply conditions. Thus, the market-based approach proposed by the Commission will create economic signals necessary for the efficient operation of the emerging competitive access marketplace.

Knowing that ILEC pricing will move towards cost-based rates upon the action of the marketplace, competitors will enter if they believe that they have the ability to recover their sunk investments plus a reasonable profit over the long term. However, the longer the lag between the potential entry of competition and the ability of the incumbent to appropriately respond, the greater the inefficiency that is introduced. Under the prescriptive method, regulation can set rates for an extended period at levels that are either above competitive levels (thereby creating a price umbrella for competitors that are less efficient than the incumbents) or too low (thereby artificially foreclosing entry by new potential competitors, even though they may be more efficient than the incumbents). Thus, a prescriptive approach will create a barrier to the natural development of efficient competition.

⁵ There are important marketplace dynamics that cause prices to deviate from cost in either direction in the short run. Some of these factors include demand swings, supply shifts, changes in technology, new substitute products, changes in product characteristics, innovations.

⁶ Gordon Reply at 14.

The market-based approach provides the correct incentives for entry by new firms as well as providing incentives for efficient investment by incumbents. If prices are too high, efficient competitors will enter, induced by the transitional profit evident between current market prices and their costs. But because government has agreed not to prescribe the rates of incumbents, new entrants will also know that very quickly they will have to compete on the merits against the incumbents.

The market-based approach also provides continuing incentives for infrastructure investment by incumbents and new entrants alike, by creating the opportunity to invest in more efficient technologies and services and earn market-based profit -- *i.e.*, to maintain margin by reducing cost or by adding value. If the profit incentive is eliminated by setting rates at or below forward-looking incremental cost, there is no incentive to continue to invest, since the best that the carrier can hope for is to break even.

C. The Commission's Triggers Provide Sufficient Discipline to Prevent Abuses.

As stated in Ameritech's Comments and by Dr. Gordon⁷, there is sound economic and policy justification for the proposed triggers and resulting regulatory relief. In summary, the elimination of barriers to entry disciplines the market, since incumbents know that, if prices become too high, IXCs can use

⁷ Ameritech's Comments at 38,45; Gordon Reply at 19-25.

network elements as a substitute in the short run and that in the long run such prices will result in additional competitive entry.

As Dr. Gordon points out, there is a direct link between the triggers and regulatory relief.⁸ Phase I relief is based on proof of the opening of the local exchange and exchange access market to competition. The proposed regulatory relief -- price deaveraging, volume and term discounts, contract and RFP ability, deregulation of new services, reduction in the X factor -- is consistent with preparing for the onset of competition and sending proper signals to potential new competitors. If this relief is not granted, competitors will be given false economic signals since they would be forced to assume that regulation will not allow market forces to drive access pricing.

Once barriers to local competition have been eliminated, the proposed regulatory relief in Phase I of the market-based approach poses no threat to the public interest. On the contrary, as demonstrated by Dr. Gordon this relief will facilitate competition and allow prices to begin moving promptly towards rational and efficient structure driven by potential and real competition, thus furthering the public interest.⁹

⁸ *Id.*

⁹ *Id.*

As Dr. Gordon proves, concerns that the triggers are unsubstantiated in their ability to discipline the market is incorrect.¹⁰ The availability of interconnection, unbundled elements and the other elements of the triggers have set in motion irreversible competition. However, even if these triggers did not immediately result in actual competition, it is clear that they are sufficient to provide the discipline necessary to prevent abuse. Moreover, a review of the history leading to these requirements in the Act, and Ameritech's Customers First Plan which preceded the Act, shows that these triggers are precisely the requirements that competitors insisted on for the opening of the local exchange and exchange access businesses to competition. It is disingenuous for them now to say that they are somehow unproven or untested, when they are exactly what they requested.

D. Price Caps Is An Important Regulatory Safeguard During The Transition To Competitive Markets.

MCI raises a litany of alleged concerns with respect to price cap regulation and its efficacy in curbing competitive abuses.¹¹ However, as Dr. Gordon demonstrates,¹² these arguments fail to recognize the important fact that price caps in conjunction with eliminating barriers to competition is an effective

¹⁰ *Id.*

¹¹ See Kwoka Affidavit at 3-10.

¹² Gordon Reply at 25-26.

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transitional mechanism to competition. Consistent with the Congress' intention to substitute competition for regulation, it is now time to reduce regulation. This means providing the flexibility for regulated carriers like the ILECs to respond as they face entry and competition.

MCI notes that price caps provides some of the incentives for the regulated firm to perform like a competitive firm. But MCI argues that it does not assure that the regulated firm will not behave anticompetitively when confronted with entry.¹³ It also raises concerns about the ability of an ILEC to manipulate price caps to frustrate competition by using the maximum flexibility allowed within the regime (and seeking more of the same) to set prices to discourage entry. But, as Dr. Gordon demonstrates,¹⁴ MCI misses the point. With all parts of the market open to competition through interconnection and unbundled network elements, there will be little or no opportunity to engage in these kinds of activities MCI postulates since there will be significant pockets where potential competition could not emerge. In fact, in the Ameritech region the earliest local exchange competition began not in Detroit and Chicago but in Grand Rapids, Michigan, and in Springfield, Illinois.

¹³ See Kwoka Affidavit at 3-10.

¹⁴ Gordon Reply at 19-25.

E. Pricing Flexibility Is Necessary Under Phase 1.

Geographic deaveraging, volume and term, and contract pricing for all access charge elements are clearly appropriate rate options for an ILEC operating under the conditions that define the Commission's proposed Phase 1. High capacity and Switched Transport services have had zone, volume, term, pricing flexibilities for many years; they are common in the industry and have been accepted by many telecommunications providers. Transport competition had flourished in a time when ILECs have had the ability to offer volume, term, and geographically deaveraged pricing. In addition, Ameritech has had contract pricing authority for intrastate access services in Illinois and competition had prospered.

Therefore, in Phase I under the Commission's market-based approach, an ILEC should be able to geographically deaverage its rates based upon unique sets of zones for each major access-related "service" -- *i.e.*, SLC, local switching, transport. Zones already implemented by ILECs in response to the Commission's expanded interconnection order are not necessarily appropriate for other services. Therefore, the Commission should not mandate that transport zones apply to other services.

AT&T routinely offers volume, term, and contract agreements at both the wholesale and retail level. Moreover these pricing plans are common practices not only in the telecommunications industry but span many other industries

operating in the United States. Clearly, these pricing flexibilities have fostered competitive development in the past and will continue to do so in the future.

Competitive/RFP response tariffs work to improve network efficiencies, promote competition, and reduce prices. The ILEC's ability to offer volume, term and competitive/RFP response tariffs on "integrated" transport and switching services is a market necessity. The telecommunications industry is composed of "sophisticated customers" that have come to expect contract negotiation as part of the telecommunications purchase decision. As more carriers provide contracts for telecommunications services, the bidding process becomes increasingly competitive and thus leads to lower prices. Finally, contract tariffs allow ILECs to reduce the risk of infrastructure investment since decisions are based on actual customer demand, rather than a forecast.

AT&T and MCI argue that volume, term, competitive/RFP pricing plans will allow the ILECs to lock in customers and disrupt competition.¹⁵ In fact, Ameritech's special access competitors grew at a faster rate after the volume and term offerings were introduced than before these pricing plans were implemented. AT&T was not able to lock in customers when it began offering volume, term and contract tariffs, nor was it able to disrupt competition. By giving the ILECs volume, term, and competitive/RFP pricing flexibilities for all access services, the

¹⁵ AT&T at 80-81; MCI at 58-61.

Commission can implement three essential goals of the Act -- reduced prices, improved network efficiencies and enhanced competition.

F. Safeguards Will Preclude Discrimination In Favor of BOC Affiliates.

Certain parties, concerned that any pricing flexibility will give BOCs an opportunity to favor their long distance affiliates, have suggested that any access rates that are made available by a BOC to its affiliate should be made available to others "without restriction."¹⁶ However, the Commission has already addressed this particular issue and decided that such a drastic remedy is unnecessary. In its Non-Accounting Safeguards Order, the Commission dealt specifically with a BOC's provision of exchange access services to its "272" affiliate. In that order, the Commission concluded simply that:

a BOC must make volume and term discounts available on a non-discriminatory basis to all unaffiliated interexchange carriers.¹⁷

The Commission found that further requirements were unnecessary:

We agree with Ameritech that, because the provision of services that fall under Section 272(e)(3) must either be tariffed or made publicly available under Section 252(h), unaffiliated interexchange carriers will be able to detect discriminatory arrangements. We recognize that a BOC may have an incentive to offer tariffs that, while available on a non-discriminatory basis, are in fact tailored to its affiliate's specific size, expansion plans, or other needs. Our enforcement authority under Section 271(d)(6) and Section 208

¹⁶ See, e.g., Sprint at 45.

¹⁷ In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as Amended, CC Docket No. 96-149, First Report and Order, FCC 96-489 (released December 24, 1996) ("Non-Accounting Safeguards Order") at ¶ 257.

are available to address this and other forms of potential discrimination by a BOC.¹⁸

Thus, the only requirement is that the services offered by a BOC to its 272 affiliate should be available to other similarly situated IXC's on the same terms and conditions. The Commission has indicated its willingness to evaluate whether specific conditions are unduly discriminatory as cases are brought to it.

G. The Deregulation of New Services Is Prerequisite to the Functioning of a Competitive Market.

Contrary to the assertions of MCI,¹⁹ deregulation of new access services under the market-based approach will facilitate the development of true competition and will provide several benefits to customers of access services. Allowing ILECs to develop new services and bring them to the market quickly at prices reflecting market conditions not only benefits consumers but provides the correct economic incentives for innovation by incumbents. Such innovation by ILECs also provides a powerful incentive to new entrants to introduce new innovations into their networks in order to keep pace with the incumbent.

In this regard, Ameritech proposes that the definition of a new service that would be deregulated be somewhat different than the definition of a new service under price caps. For deregulation, the service should be new in a technical sense

¹⁸ *Id.*

¹⁹ See Kwoka at 21-22.

(not simply a new pricing option). With this modification, some of the concerns about a BOC providing special “deals” to its affiliate should be allayed.

This ability to introduce new services will not impact the availability of existing core services. Under Ameritech’s proposal, core access services will continue to be available at rates regulated by price caps. Prior to “deregulation,” no access services will be able to be withdrawn without regulatory oversight, so customers of existing access services will continue to be protected. Thus, under Ameritech’s proposal, customers would not only continue to have access to existing services, they would also be able to avail themselves of the new services. With this in mind, it can be seen that the ILEC will have no undue “market power” with respect to the new service. All existing options remain open to customers -- who have been accustomed to “doing without” the new service. Since the ILEC will be introducing the new service with the hope that customers will buy it, it cannot price the service higher than its value in the marketplace.

As Dr. Gordon establishes,²⁰ ILECs will not ignore customers of core services if given the incentive to introduce new services. First, if core services are neglected, this will provide the opportunity for CLECs and others to enter. Second, it is in the interest of the ILEC to continue providing affordable, effective core services, as long as there is the potential to profit from doing so. Under the

²⁰ Gordon Reply at 24-25.

market-based approach, those incentives continue throughout the transition to a market-based access environment.

III. THE PRESCRIPTIVE APPROACH SUBVERTS COMPETITION AND CONSUMER WELFARE.

A. The Prescriptive Approach Is Inconsistent With Pro-Competitive Goals.

Congress states loud and clear that competition is to provide the discipline to guide the evolution of telecommunications markets. Thus, where regulation is to continue, it should ensure that competitors have access to essential services and facilities such as interconnection. Those favoring the prescriptive approach fail to argue convincingly that such a restructure and inflexible approach to pricing is required by the Act or consistent with its pro-competitive goals. Clearly, a return to what is equivalent to rate of return regulation is not a step forward, either to competition or deregulation. Congress provided the tools by which competition in local exchange and exchange access services can develop. As Dr. Gordon demonstrates,²¹ the kind of extensive rate regulation inherent in the prescriptive approach is inconsistent with the development of that competition and as discussed below, would frustrate, and even stifle, the natural development of competition and efficient market solutions.

²¹ Gordon Reply at 13-17.

B. The Proposed Prescriptive Approach Would Harm Competition and Consumer Welfare.

The prescriptive approach, as described in the NPRM, would fail to facilitate efficient competition. Setting rates to only recover forward-looking costs of the most efficient conceivable firms would stifle facility based competition and network investment, thereby harming competition and consumers. Also, setting rates at some level of theoretical or actual costs would not reach a "competitive" outcome and would impair the ability of the market to freely operate to produce such an outcome.

Even if it were possible to determine the efficient forward-looking costs of providing service (which it is not), prescribing rates to these levels could lead to serious adverse consequences to long term consumer welfare and competition. As Dr. Gordon demonstrates,²² in competitive markets, there is a distribution of firms with different cost and operating structures. A prevailing market price is determined by the interaction of all suppliers and consumers and over the long run will be at the level of the actual costs of the least efficient firm able to stay in the market and vie for customers. In other words, although over time prices tend to move toward cost in a competitive market, they never in the long run settle at the incremental costs of the most efficient provider. This is an efficient result

²² *Id.* at 13-14.

because it provides profit incentives for new entrants and for increased investment by incumbent firms.

But prescribing rates based on the costs of the least efficient firm is inefficient. This process would be an administrative nightmare and would not lead to an efficient outcome since the market would not have the flexibility to respond to changing demand, supply and other conditions. A further complicating factor in the telecommunications industry is that the incumbent LECs bear very substantial additional costs of social and regulatory policies that are not imposed on new entrants.

As Dr. Gordon demonstrates,²³ the prescriptive approach would lead to an efficient outcome only by accident, and then that condition would not be sustainable over time due to the dynamic nature of the market. The Commission will simply not have the ability to discern which sets of costs are the correct costs for the purpose of prescribing rates. In particular, proxy models being considered by the Commission provide estimates of future costs of hypothetical hyper-efficient firms that do not and will not ever exist. Thus, they have no relation to what will be the costs of any real competitor, and may differ from actual costs by margins unknown to the Commission.

As a consequence, rates prescribed based upon any cost methodology would be set either too high or too low. This would lead to inefficient or too little entry,

²³ *Id.* at 17.

too much or too little investment. Efficiency would be frustrated on all counts. In fact, if prices were set at forwarding-looking incremental cost, it is likely that little or no real competition would develop since there would be no economic incentive to drive it.

Thus, the prescriptive approach is not harmless -- at best it would frustrate efficiency and, more likely, it would stifle the development of real efficient competition.

C. The Potential Emergence of Competition Eliminates the Need for Prescription.

MCI contends that there is no competition and that there may never be any, so the Commission cannot be certain that the market-based approach will succeed.²⁴ However, MCI has it backwards; if the Commission adopts the prescriptive approach, it will virtually guarantee that efficient competition will not emerge. The market-based approach is the only method available that gives real competition a chance to develop.

Moreover, MCI's contention that there is no competition and that, therefore, the market-based approach cannot be adopted is factually incorrect. First, competition had already developed prior to the Act. Many cities have alternative access providers which, until now, have specialized in the provision of

²⁴ MCI at 47. MCI claims (at 55) that LECs have offered no evidence that the special competitive circumstances that exist in NYNEX's LATA 132, exist elsewhere. MCI completely ignores Ameritech's Customer's First Plan and the waiver the Commission granted.

special access and, in a limited number of instances, switched access. Competition has been successful in these areas, with dedicated access prices, especially for High Cap services, falling by 10% to 40% over the last several years depending on the location and the incumbent's initial price levels.

These facilities-based providers are providing or are in the process of preparing to provide switched access and local exchange services through the addition of switching and other operational and marketing capabilities. Moreover, with the availability of unbundled network elements, the sunk costs of entry are dramatically reduced or eliminated. Given the extensive competition in special access and the relatively low sunk costs of entry into switched access, AT&T's claim that future competition is uncertain is far-fetched.²⁵

Moreover, the market-based approach proposed by the Commission does not provide outright deregulation before competition emerges. At the initial stages of the approach, flexibility is given to those ILECs that have opened their services to competition. It does not deregulate them. Price caps are still in place; only new pricing flexibility is granted. The success of competition in special access provides the evidence to suggest that potential competition provides discipline to ILEC access pricing as actual competition is never far away. Of course, in many cities switched access competitors have made significant inroads.

²⁵ AT&T at 45-48.

In the Ameritech region this includes, Chicago, Detroit, Grand Rapids and Springfield.

D. The Prescriptive Approach Is an Inferior Substitute for Existing Safeguards.

The IXCs argue that the prescriptive approach is the best means of avoiding any potential price squeeze in the interLATA business.²⁶ However, this argument ignores that there are more than adequate safeguards to prevent anticompetitive actions in interLATA services that are far less intrusive than prescription on the development of competition. For instance, the Commission noted that the Act's nondiscrimination requirements are prophylactic measures that address this issue. Moreover, there is no real world incentive to engage in such behavior. As Dr. Gordon demonstrates,²⁷ the price squeeze hypothesized by commenters is simply not in the economic interest of the RBOC except in very limited circumstances which are not present and will likely never be present.

The prescriptive approach in fact may create a price squeeze of a different kind. As discussed above, it is highly unlikely that the Commission would be able to choose the "correct" cost for setting prices, or that any such correct price would remain so for very long in a dynamic marketplace. If it mandates access rates that

²⁶ AT&T at 13-16; MCI at 35-37.

²⁷ Gordon Reply at 22-23.